

Economic Outlook



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May 1988

The economic expansion continues to roll along, creating new jobs and pushing unemployment down. At 5.4%, unemployment now stands at its lowest level in fourteen years. The first quarter pattern of GNP growth set the stage for a solid second quarter. Earlier concerns about excessive inventory cutting into future production were exaggerated. While consumer spending is likely to moderate from its strong first quarter rebound, the capital goods and export boom should add enough additional momentum to keep the economy growing at a healthy pace. Strength in these sectors will also help sustain the expansion by adding needed capacity and restoring a better balance in U.S. external accounts. Nevertheless, inflation pressures are building in the U.S. and elsewhere as aggregate demand strains capacity in more industries and the labor market continues to tighten.

Total consumer spending was very strong in the first quarter, largely reflecting a surge in automobile purchases, after a steep decline in last year's final quarter. Increased spending on services also made an important contribution to first quarter growth with health services among the fastest growing segments in the economy. An aging population and a continuing trend toward medical treatment for psychological and substance abuse problems account for the strength in health services. These are long run trends that are likely to continue. The skyrocketing demand for medical services has kept services inflation much higher than inflation in other sectors and health benefit costs to employers are reflecting this pressure, rising in significance as part of overall labor costs. This is also an area where employment growth is most rapid. On the negative side, consumer purchases of nondurable goods slipped for the fourth quarter in a row and currently show little sign of reviving. While the real value of consumer spending on food, clothing, gasoline, and other nondurable goods is weak, the nominal or dollar level of spending has been growing, leading some analysts to suspect price discounting is not being adequately reflected in the GNP statistics. In any event, consumer spending is likely to continue on the modest growth path it has followed the past several months, when adjusted for sharp quarter-to-quarter swings in auto purchases. Strength in services and durables should be sufficient to offset weak nondurable goods consumption. The strong labor market will keep consumer confidence and spending from fading any time soon.

Business spending is making a significant contribution to economic growth. Over the past year, purchases of producer durable equipment grew around twenty percent. Capital goods industries showed strong employment growth in April and the backlog of unfilled orders for durable goods continues to mount. Factory hours, overtime, and earnings all showed solid increases in April. Increased car production schedules are also helping to boost second quarter output. Domestic auto inventories slimmed down considerably during the first quarter and entered the spring season at or below desired levels. Business services is another fast growing

sector with computer and personnel services leading the way. Nonfarm inventories increased quite a bit in the first quarter as large declines in retail inventories, especially cars, were more than offset by big gains in manufacturing and wholesale inventories. Closer scrutiny shows a normal build-up of machinery and other durable goods inventories as activity in this area has heated up. With large order backlogs, there is little danger that these stocks will prove excessive.

The strength in demand for capital goods has stimulated imports of durable equipment because many producers rely on international sources. Unfortunately, this hurts the trade deficit. However, imports of automobiles are dropping now as bloated inventories and shifts to U.S. production facilities slow the huge inflow of foreign automobiles. This will mitigate the impact of increased capital goods imports. Inventories of imported cars, unlike domestic cars, continued to build through the first quarter to record levels. Also helping the trade picture is the continuing surge in nonagricultural merchandise exports which grew about twenty percent over the past year.

All in all, the latest statistics confirm a picture of an economy in the late phases of economic expansion with shrinking margins of excess capacity outside the auto industry and a diminishing supply of unemployed workers to fill the jobs created by continued expansion. Unless domestic demand tapers off, inflation is likely to show further acceleration as the year progresses.

Robert T. McGee

Real GNP

(Percent Contribution to
Real GNP Growth; Annual Rates)

	Actual				Forecast				Actual		Forecast		
	1987		1988		1988		1989		1986- 1987		1987- 1988- 1988 1989		
	II	III	IV	I	II	III	IV	I					
Consumer Spending	1.2	3.5	-1.7	2.4	0.7	0.7	0.7	0.4	1.3		1.1	0.5	
Business Investment	1.3	2.8	0.2	2.4	1.5	1.0	0.6	0.6	0.1		1.5	1.0	
Residential Investment	-0.2	-0.4	0.4	-0.5	0.1	-0.1	-0.1	-0.2	0.0		-0.1	-0.2	
Change in Inventories*	-1.6	-1.5	4.9	-1.9	-0.3	0.3	0.3	0.5	0.4		0.1	0.0	
Net Exports	0.3	-0.6	0.3	0.4	1.1	1.0	0.9	0.8	0.3		0.5	0.6	
Government Purchases*	1.5	0.5	0.7	-0.5	0.5	0.5	0.5	0.5	0.8		0.3	0.4	
Real GNP	2.5	4.3	4.8	2.3	3.6	3.4	2.9	2.6	2.9		3.4	2.3	

Quarterly Economic Indicators

(Percent Changes
at Annual Rates)

	Actual				Forecast				Actual		Forecast		
	1987		1988		1988		1989		1986- 1987		1987- 1988- 1988 1989		
	II	III	IV	I	II	III	IV	I					
Nominal GNP	6.3	7.3	7.3	4.7	8.1	9.0	8.7	8.7	6.0		7.1	8.5	
GNP Deflator	3.5	2.8	2.7	2.4	4.5	5.3	5.7	6.0	3.0		3.5	6.1	
Corporate Profits After Tax†	10.0	9.0	8.7	12.5F	10.1	8.5	6.9	6.4	8.7		9.5	6.0	

Monthly Economic Indicators

	Recent Data			Actual 1987	Forecast	
	Feb.	Mar.	April		1988	1989
Consumer Price Index** (%)	0.2	0.5	n.a.	4.4	5.3	6.2
Industrial Production (%)	0.0	0.1	n.a.	3.7	5.1	2.7
Retail Sales (%)	0.6	0.8	n.a.	5.1	5.4	5.2
Auto Sales (million units, a.r.)	11.0	10.7	10.5	10.3	10.1	8.8
Housing Starts (million units, a.r.)	1.51	1.54	n.a.	1.63	1.53	1.35
Unemployment Rate (%)	5.7	5.6	5.4	6.2	5.5	5.5
Merchandise Trade Balance (\$ bn., a.r.)	-165.9	n.a.	n.a.	-171.2	-145.0	-110.0

*Adjusted for CCC purchases.

**Annual percent changes are December to December.

May 9, 1988

†Quarterly data are year-over-year percent changes.

F = Forecast

a.r. = annual rate